11/26/86 R550-2

JAPAN ECONOMIC INSTITUTE

JEI

REPORT

NO. 3A January 24, 1986

OUTLOOK FOR THE JAPANESE ECONOMY IN FY 1986

Summary

Japan's current economic expansion, which began in March 1983, has now lasted longer than the average of 25 months in recent years. Strong economic growth, initiated by exports and supplemented by capital investment, has increased per-capita gross domestic product to over $10,000, the ninth-largest in the world. The government forecasts continued strong economic growth of 4 percent in real terms in FY 1986. Private sector economists, however, are unanimous in predicting slower growth and many believe the economy has reached a turning point.

Real growth in FY 1986, which should be about 3 percent, will result entirely from an expansion of domestic rather than external demand, due to the appreciation of the yen. While low inflation of less than 2 percent will encourage personal consumption, falling corporate income will lower wage increases, restraining the rise in personal consumption. Smaller profits will also curb business investment. Government fiscal policy should have a modest stimulative effect, however.

The Government Forecast

Despite the adverse effects of a strong yen, the Japanese government's economic outlook for FY 1986 (April 1, 1986-March 31, 1987) envisages a 4 percent real growth rate. According to the Economic Planning Agency, external demand will have a negative effect on growth for the first time since

FY 1978. Net exports have played an important role in the current expansion, accounting for one-fourth of the 18 percent increase in real gross national product. Now, however, the EPA is counting on a significant jump in domestic demand to maintain growth near the 4.2 percent rate expected during the current fiscal year (see Table 1).

Forecasts from 11 major Japanese banks and research institutions for FY 1986 range from 2 percent inflation-adjusted growth to 3.8 percent (see Table 2). The average prediction of a 3 percent increase represents the lowest rate since FY 1974 when the first oil crisis led to no growth. Many of the forecasts assume that the government will adopt more stimulative fiscal and monetary policies. The 3.8 percent rate projected by the Research Institute of the National Economy, for example, assumes that both Japan and the United States will lower their official discount rates and that Tokyo will pursue a more expansionary fiscal policy. Absent such actions, the institute puts growth at only 2 percent.

The government forecast is surprising in light of the November EPA report noting a slowdown in the expansion and EPA director-general Ippei Kaneko's early December statement that 4 percent growth would be hard to attain. Some observers speculate that the official figure is merely a policy target based on political considerations. With the May summit approaching, the government is anxious to demonstrate that it is serious about fulfilling its commitment to stimulate domestic demand.

External Demand

Government economists expect external demand in FY 1986 to offset 0.2 percentage point of domestic demand's projected 4.2 percentage point contribution to inflation-adjusted growth. EPA forecasters say that the current account surplus will stay at FY 1985's estimated $51 billion level and the trade surplus will fall by $2 billion to $56 billion, while private predictions of the FY 1986 current account surplus range from $42 billion to $64 billion. Export forecasts range from Sumitomo Trust & Banking Co., Ltd.'s 4 percent contraction to the Research Institute for National Economy's 4.2 percent rise.

One reason for the wide disparity is differing assumptions on the strength of the yen and the rate of U.S. economic growth. Tokai Bank, Ltd., which predicts only 2 percent overall real growth, bases its forecast on an average exchange rate of Y187=$1.00 and 2.4 percent economic growth in the United States, leading to a 2.5 percent decline in exports. The Research Institute of the National Economy's more optimistic 3.8 percent growth projection, in contrast, assumes an exchange rate of Y209=$1.00 and U.S. expansion of 3.1 percent, translating into a 4.2 percent increase in exports.

Any forecast of the Japanese economy depends heavily on both these factors, which are detailed below.

The JEI REPORT (ISSN 0744-6489) is published weekly for $40 per year by the Japan Economic Institute of America, 1000 Connecticut Avenue, N.W., Washington, D.C. 20036. Second class postage paid at Washington, D.C. POSTMASTERS: Send address changes to JEI, 1000 Connecticut Avenue, N.W., Washington, D.C. 20036.

Table 1: Japanese Government FY 1986 Forecast

(percentage change in real terms)

	Actual			Estimated	Projected
	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986
Gross National Product	3.2%	3.7%	5.0%	4.2%	4.0%
Consumer Spending	4.2	3.1	2.6	3.0	3.6
Residential Construction	1.2	-9.0	0.4	3.1	4.6
Capital Spending	2.0	4.9	10.9	11.5	7.5
Current Account Surplus*	$9.1	$24.2	$37.0	$51.0	$51.0
Trade Surplus*	$20.1	$34.5	$45.6	$58.0	$56.0
Wholesale Prices	1.0	-2.3	0.2	-2.4	-1.8
Consumer Prices	2.4	1.9	2.2	2.1	1.9

*in billions of dollars

Source: Economic Planning Agency

Table 2: Summary of Private Forecasts for FY 1986

(percentage change in real terms)

	GNP	Consumer Spending	Capital Spending	Exports	Current Account Surplus*	Y/$ Exchange Rate
Tokai Bank, Ltd.	2.0%	2.9%	3.8%	-2.5%	$42.0	Y187
Mitsubishi Research Institute	2.1	2.4	1.7	-2.3	58.3	207
Meiji Life Insurance Co., Ltd.	2.7	2.6	4.4	1.7	52.0	205
Sumitomo Trust & Banking Co., Ltd.	3.0	4.7	4.7	-4.0	43.2	195
Dai-Ichi Kangyo Bank, Ltd.	3.0	3.2	6.3	0.9	58.0	200
Nikko Research Center	3.0	2.7	4.3	-3.8	54.4	200
Bank of Tokyo, Ltd.	3.1	3.4	5.0	-0.5	47.6	198
Japan Economic Research Institute	3.2	3.2	4.1	1.1	63.9	202
Nomura Research Institute	3.3	3.2	4.5	-0.2	52.4	193
Japan Research Institute	3.5	3.7	4.7	3.1	51.2	200
Research Institute of the National Economy	3.8	2.9	5.0	4.2	63.4	209

*in billions of dollars

Source: Japan Economic Journal, December 23, 1985, p.4

Outlook For The Yen - In 1985 the yen climbed to its highest value against the dollar since 1981. By year-end, it had appreciated over 28 percent from its February low, with about two-thirds of this increase following the September 22 G-5 agreement to lower the value of the dollar. Intervention in exchange markets and a hike in short-term interest rates encouraged the appreciation of the yen.

There have been signs that Tokyo plans to ease the tight monetary policy that has boosted the yen at the expense of economic growth. On December 18, Bank of Japan governor Satoshi Sumita announced that the bank would gradually move away from its policy of raising short-term interest rates. Mr. Sumita said the bank's decision was based on the narrowing of the interest rate differential between Japan and the United States and the firmness of the yen at around Y200=$1.00.

The EPA forecast of an average exchange rate of Y204=$1.00 appears to be an appropriate assumption. Tokyo is unlikely to take policy steps that would undermine the appreciation of the yen -- an appreciation that has been effective in dampening protectionist pressures in the Congress. Although anxious to stimulate domestic demand through lower interest rates, the central bank is said to be waiting for a fall in the U.S. discount rate before cutting its own for fear that another widening of the interest rate gap would lower the value of the yen. The government appears satisfied with a rate around Y200=$1.00 but any rise in the yen above that mark would probably be offset by a decli[illegible] in Japanese interest rates.

U.S. Economic Outlook - The pace of economic growth in the United States, which buys more than one-third of Japanese exports, played a major role in Japan's strong expansion in 1984 as well as in the 1985 slowdown. In FY 1984 the increase in net exports to the United States exceeded the total rise in net exports, which in turn was responsible for one-fourth of Japan's economic growth in that year. If the associated increase in investment is included, the United States was responsible for well over one-fourth of Japanese growth in the April 1984-March 1985 period.

The United States is entering the fourth year of economic expansion, a span far longer than the average of 27 months achieved in 25 peacetime cycles. The upturn since late 1982, a result of the successful anti-inflation program initiated by the Federal Reserve Board in November 1979 and stimulative government fiscal and monetary policies, can be divided into two distinct periods. During the first 18 months, real GNP growth averaged 7 percent, but from mid-1984 through 1985, output gains averaged only 2.3 percent.

Debt-service problems stemming from the large accumulation of public and private debt will eventually restrict consumption and investment, slowing economic activity. Consumers have a total debt of over $2 trillion, business has added $350 billion of debt during the past two years, and the national debt has risen from $930 billion in 1980 to $1.8 trillion. But given the fiscal and monetary stimulus already in place, a recession during 1986 is unlikely. Monetary policies are likely to remain accommodative until fundamental GNP and inflation signals change. The Gramm-Rudman-Hollings legislation, designed to eliminate the government budget deficit by 1991, mandates only $12 billion in spending cuts during 1986, and expectations of falling deficits have encouraged a drop in long-term interest rates to their lowest level since 1979.

The U.S. economy is likely to grow about 3 percent in real terms in 1986. Consumer spending should continue to be strong, with inflation moderate and interest rates lower. Personal income will increase as employment rises and individual portfolios reflect rising stock and bond prices. Given the fall in the personal saving rate from its 7 percent average of the past 10 years to 3.5 percent in the third quarter of last year, some observers expect consumption to decline as consumers attempt to return to normal conditions. It is likely, however, that consumers now consider the increasing value of their financial assets and durable goods to be substitutes for traditional savings. Furthermore, the debt and saving figures reflect demographic changes that have increased the number of people in the 25- to 44-year-old age bracket.

Although changes in inventories and net exports of goods and services are only a small component of total GNP, the volatility of these factors gives them a direct impact on the cyclical pattern. The liquidation of inventory stocks in 1985 was a major factor in holding down the overall growth rate just as the rapid accumulation of inventories in 1983 and 1984 was a crucial element in the economic recovery. Given the low inventories-to-sales ratios in most sectors, it is likely that stocks will have to be replenished in 1986. Net exports should also begin to contribute to GNP later this year, as the sharp 25 percent drop in the trade-weighted value of the U.S. dollar against other major industrial currencies since February 1985 eventually reverses the deteriorating trade balance.

The major threat to continued U.S. economic growth is renewed inflation resulting from both the unusually rapid growth of money and credit and rising import prices. But moderate wage settlements and productivity gains should restrain unit labor costs and contain inflation. Furthermore, declining oil and other commodity prices and intense international competition will promote price stability.

Net Exports - Some of the optimistic forecasts of Japan's export growth are based on its performance in the 1979-80 period following the appreciation of the yen. With the yen at Y175=$1.00 in October 1978, exports rose 12.8 percent in real terms in FY 1979 and 16.6 percent in FY 1980. Rapid growth and high inflation in the United States and other industrialized countries enabled Japanese exporters to raise prices by the full amount of the yen's appreciation without sacrificing export volume.

With today's drastically different international environment, however, the effect of the yen's appreciation is likely to be different. The rise in the yen comes at a time when exports are already slowing due to sluggish growth overseas (see Table 3). The moderate pace of inflation makes it difficult to raise prices by the full appreciation of the yen. In 1979 Japanese auto makers raised their U.S. prices 15 percent, but in today's competitive compact car market, such a price rise would reduce the share of Japanese makes. Moreover, competitors in many industries in Taiwan, Hong Kong and Korea stand ready to benefit from higher prices for Japanese goods. Japanese exporters, therefore, will likely raise prices only one-third to one-half the amount of yen appreciation, and concentrate on reducing production costs and moving to upscale products.

In October 1985 Japan's export volume was up 2.5 percent from a year earlier. Exports rose 7.5 percent in dollar terms but fell 3.2 percent in yen

Table 3: Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	FY 1983	FY 1984	October-December 1984	January-March 1985	April-June 1985	July-September 1985
Gross National Product	Y267,782.0 (3.7%)	Y281,102.2 (5.0%)	Y284,215.8 (8.9%)	Y285,425.7 (1.7%)	Y289,447.6 (5.8%)	Y291,298.9 (2.6%)
Personal Consumption Spending	155,008.7 (3.1%)	159,100.7 (2.6%)	159,240.9 (2.2%)	161,106.4 (4.8%)	161,900.4 (2.0%)	162,753.3 (2.1%)
Private Residential Construction	13,635.6 (-9.0%)	13,688.4 (0.4%)	13,742.5 (3.5%)	13,913.9 (5.1%)	14,227.9 (9.3%)	13,892.6 (-9.1%)
Private Fixed Nonresidential Investment	42,672.2 (4.9%)	47,342.6 (10.9%)	48,452.9 (17.1%)	48,574.5 (1.0%)	51,124.5 (22.7%)	52,770.0 (13.5%)
Change in Business Inventories	988.8 (-16.9%)	1,839.1 (86.0%)	1,950.7 (-1.3%)	2,112.0 (37.4%)	1,825.3 (-44.2%)	1,384.0 (-66.9%)
Government Current Expenditures	26,050.2 (3.5%)	26,654.9 (2.3%)	26,675.0 (2.1%)	26,979.1 (4.6%)	27,081.5 (1.5%)	27,190.4 (1.6%)
Government Fixed Investment	22,848.1 (-2.2%)	22,159.9 (-3.0%)	22,014.9 (-8.5%)	21,615.5 (-7.1%)	19,954.0 (-27.4%)	20,456.1 (10.5%)
Change in Government Inventories	-227.9 (*)	159.1 (*)	42.6 (*)	27.9 (*)	77.6 (*)	515.6 (*)
Net External Sector	6,806.2 (135.8%)	10,157.3 (49.2%)	12,096.4 (408.5%)	11,096.4 (-29.2%)	13,256.4 (103.7%)	12,336.9 (-25.0%)
Exports of Goods and Services and Factor Income Received	46,313.9 (8.7%)	53,609.8 (15.8%)	55,256.5 (20.9%)	54,833.7 (-3.0%)	57,176.9 (18.2%)	55,149.3 (-13.4%)
Imports of Goods and Services and Factor Income Paid	39,507.7 (-0.5%)	43,452.4 (10.0%)	43,160.1 (-12.6%)	43,737.3 (5.5%)	43,920.5 (1.7%)	42,812.4 (-9.7%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

terms, reflecting the higher yen. The rise in volume despite the yen's appreciation reflects the long lag between the placement of orders and the negotiation of new contracts. Later in 1986 the effect of the stronger yen should begin to be reflected in falling export volumes, further reducing the value of exports in yen terms. But with U.S. growth at around 3 percent and the yen hovering around Y200=$1.00, the decline should not exceed 4 percent.

Assuming import demand is responsive to price changes, the appreciation of the yen should boost imports. But demand for agricultural and industrial raw materials, which account for almost three-fourths of Japanese imports, is relatively insensitive to price changes. The decline in oil prices, which still account for more than a quarter of total purchases, will also lower Japan's import bill. Furthermore, slower growth will restrain demand for foreign goods. In sum, there should be a small decline in imports in FY 1986.

On balance, therefore, the external sector should have a small negative effect on growth in FY 1986. The current account surplus denominated in dollars, though, should rise by several billion dollars from the $52 billion forecast for the current year. With Japan now the largest creditor nation, a declining deficit in the services account will encourage the higher surplus.

Domestic Private Demand

The EPA projection calls for private domestic demand to provide 3.5 percentage points of its 4 percent growth forecast for FY 1986. Detailed analyses of the outlook for personal consumption, residential construction and business investment follow:

Personal Consumption Spending - The government expects the growth of personal consumption spending, which accounts for almost 60 percent of GNP, to accelerate from 3 percent during the current fiscal year to 3.6 percent during FY 1986. The EPA is counting on falling oil prices and the stronger yen to hold the increase in the consumer price index to below 2 percent. Inflation is well under control, as shown by the tenth consecutive monthly decline in the wholesale price index in December. After three consecutive yearly talks, producer prices are now 3.4 percent less than in 1980. Lower inflation, in turn, will increase consumers' real income gains and raise consumption expenditures.

The anticipated increase in consumption resulting from last spring's 5 percent wage increase and a 6 percent rise in the summer bonus has thus far failed to materialize: the actual increase in worker's income has been less than expected due to a decline in overtime. Consumer spending in real terms increased at a modest 2 percent rate in the first half of the current fiscal year.

Achievement of the government's consumption target requires healthy wage and bonus increases this year. But with the slowing in export growth, there will also be less overtime work. Moreover, given the decline in corporate earnings in the current fiscal year, the gains in workers' income are likely to be modest. The winter bonus was only 4.4 percent higher than 1984's, and Nomura Research Institute predicts that the wage increase this spring will be only 4.5 percent. These figures imply real income gains of around 2.5 percent

to 3 percent, making the government's 3.6 percent target for consumption spending appear too optimistic.

Daiwa Securities Co., Ltd. forecasts that an oil price decline of $5 per barrel will boost corporate profits 5.2 percent and raise GNP one-quarter of a percentage point. While a decline in oil prices will certainly help, its impact will be muted by Japan's great success in reducing its dependence on oil. Oil imports fell from nearly 5 million barrels a day in 1973 to 3.7 million barrels in 1984. Oil now accounts for less than one-third of the country's imports and its consumption of imported energy is now under 5 percent of GNP -- less than the rates for West Germany, France, Britain and Italy.

Private Residential Construction - Investment in housing construction accounts for less than 5 percent of GNP but has a significant impact on the rate of growth. Housing investment increases overall production by 2.2 times the original investment, compared to only 1.7 times for household consumption. The volatility of residential construction, which has been negative in three of the past five fiscal years, makes it a significant factor in determining overall growth. The decline in housing investment in FY 1983, for example, lowered economic growth by 1.1 percentage point.

Increased residential construction has received political support, both in Japan and abroad, as a way of reducing Japan's huge trade surplus. Many observers suggest that the quality of the housing stock in Japan, where units are on average 31 percent smaller than in the United States, should be improved. Expanded housing investment would absorb the household sector's surplus savings and reduce capital outflows, raising the value of the yen and leading to more imports and fewer exports.

The government hopes that tax incentives will help increase residential construction to its FY 1986 target of 4.6 percent growth. There are tentative plans to grant a tax credit to new homeowners who have borrowed from the government's Housing Loan Corp. Price trends should also encourage housing investment. Increases in the price of land are expected to remain moderate, while the cost of building materials fell in 1985 and the interest rate charged by city banks on housing loans is now at a low 7.7 percent.

Housing investment was sluggish in the first half of FY 1985, although housing starts last fall increased above year-earlier levels. The EPA estimates that housing investment will rise by 3.1 percent in real terms during the current fiscal year, which would be the biggest gain since FY 1978. But unless there is a sharp increase in demand, housing investment in FY 1986 is unlikely to reach the government's target.

During the past 20 years, Japan has built 26.6 million residential units and its housing stock of 38.7 million units exceeds the nation's 35.3 million households. Japan's population is now growing at only a 0.7 percent annual rate and there were only 760,000 marriages in 1983 compared to more than one million each year in the early 1970s. Furthermore, the era of heavy migration to urban areas has ended and the decline in average family size from 4.97 in 1955 to 3.33 in 1980 has reduced the incentive to acquire more spacious housing.

Although housing is more affordable, as shown by the decline since 1980 in the ratio of housing prices to worker's average annual income, buyers cannot count on large annual wage increases to make mortgage payments progressively easier. Furthermore, speculative purchases today are directed more at financial assets than real estate. Investment in houses and land was encouraged in the 1970s by the fact that real estate prices rose more rapidly than wages and inflation. Since 1981, however, the increase in housing and land prices has been less than the inflation rate and the rise in wages.

Although the number of housing starts, which fell from a peak of 1.86 million units in FY 1972 to 1.14 million in FY 1983, has been rising in the past two years, the increase in the value of investment has lagged for several reasons. First, greater use of prefabricated components has lowered construction costs. Second, a larger proportion of new construction is in rental housing, which requires less investment per unit. Several supply-side factors also continue to constrain residential construction. Construction firms complain that such units are no longer profitable as builders are required to bear the rising financial burden of building roads, schools and other public facilities. Then, too, local government regulations have become so rigid as to discourage residential construction.

Private Plant and Equipment Investment - Business investment has been a leading sector in the current expansion, increasing 10.9 percent in FY 1984 and an estimated 11.5 percent in FY 1985 (although the current fiscal year figure is exaggerated by the inclusion of Nippon Telegraph and Telephone Corp. and the tobacco monopoly, Japan Tobacco Inc., which were both privatized last April). Despite slowing exports, the EPA expects business investment, which accounts for about 16 percent of GNP, to grow 7.5 percent in real terms in FY 1986. Most private sector forecasts fall in the 4 percent to 5 percent range.

After setting records in FY 1984, corporate profits are expected to decline by about 5 percent this fiscal year as a result of a slowdown in the electronics industry, which accounts for about 25 percent of corporate earnings, and the rise in the yen. While the stronger currency benefits those industries such as utilities that depend on imports of raw materials, it has cut into the profits of exporters, which have generally limited price hikes to 5 percent to 10 percent. This decline in earnings has slowed the increase in investment spending from 13.4 percent in the first half of FY 1985 to 3.5 percent in the second, according to an EPA survey.

Large corporations are likely to take a long-term perspective in making capital investment decisions, as they remain concerned about their future competitiveness. Business investment should therefore continue to grow in FY 1986, though at a slower pace of about 5 percent to 6 percent.

Government Economic Policies

The draft budgets for FY 1986, which will probably be adopted intact by the Diet, attempt to accommodate two contradictory demands. As part of the government's goal to end reliance on debt-financing bonds, discretionary expenditures are to be cut for the fourth consecutive year. In response to pressure from business circles to stimulate domestic demand, however, the Fiscal Investment and Loan Program (FILP) is projected to increase 6.2 percent and several tax breaks are expected to be introduced.

The general account budget (discretionary expenditures plus debt financing and transfers to local government) is set to rise 3 percent in nominal terms to Y54.1 trillion ($270.4 billion at Y200=$1.00), an increase below last years's 3.7 percent rise. Spending on public works, a major source of pump priming, is to be cut 2.3 percent, while debt service costs and transfers to local governments will rise 10.7 percent and 5.1 percent, respectively (see JEI Report No. 1B, January 10, 1986).

Reversing this fiscal year's decline, the FILP budget, which is financed largely by revenues from the postal savings system, will increase to Y22.2 trillion ($111 billion). Programs concerned with economic infrastructure, such as roads and water works, will receive the largest increases. In addition, outlays by prefectural governments are expected to increase 4.6 percent to Y52.9 trillion ($264.3 billion).

Minor tax reforms are expected to generate Y240 billion ($1.2 billion) more in tax revenues in FY 1986, primarily from the business sector. This increase, as well as the planned continuation of a 1.3 percent tax surcharge on corporate incomes, has brought complaints from business leaders, who claim that business taxes in Japan are higher than in Europe or the United States. Tax breaks for housing as well as plant and equipment investment are also planned.

Tax revenues, which are expected to increase in line with the government's projected 5.1 percent nominal growth rate, and non-tax revenues will total only an estimated Y43.2 trillion ($216 billion), requiring new government bond issues of Y10.9 trillion ($54.7 billion). This represents a Y734 billion ($3.7 billion) reduction from FY 1985's debt financing requirement, but falls short of the government's goal of a Y1 trillion ($5 billion) reduction each year in order to stop issuing deficit-financing bonds by FY 1990.

With the tax breaks planned and the projected increase in spending, fiscal policy in FY 1986 should have a positive effect on the economy, in contrast to the current fiscal year. But its impact will be small, probably around 0.5 to 0.7 percentage point in real terms. Many observers are disappointed with the small fiscal stimulus planned and believe that continued fiscal austerity in the face of the strong yen will slow growth and tax revenues, making it impossible to achieve the goal of fiscal stability. Fiscal policy, they say, should be more expansionary to absorb the excess savings of the household sector.

But the seriousness of the government's fiscal situation is illustrated by the rise in debt service costs to an all-time high of more than 20 percent of the general account budget. The Finance Ministry plans to issue a total of Y22.44 trillion ($112.2 billion) worth of bonds in FY 1986, with Y11.49 trillion ($57.5 billion) intended to refinance bonds falling due during the year. By the end of FY 1986, the outstanding balance of government bonds will total Y143 trillion ($715 billion).

Japan's public debt burden is large compared to other industrialized countries (see Table 4). The percentage of bond issues in total revenues, the ratio of outstanding long-term debt to GNP, per-capita outstanding long-term debt, and interest payments as a share of the total budget are all higher in Japan than in the other G-5 countries. Yet the future social security burden

in Japan, whose population will have aged more by the year 2000 than any other country's, make the tight fiscal policies of the Nakasone government more understandable.

Table 4: International Comparison of Fiscal Situations

	Percentage of Bond Issues in Total Revenues	Ratio of Outstanding Long-Term Government Debt to GNP	Per-Capita Outstanding Long-Term Government Debt	Interest Payment/Total Budget Spending
Japan	22.2% (FY 1985)	48.4% (FY 1985)	Y1,260,000 (FY 1985)	18.8% (FY 1985)
United States	19.4 (FY 1985)	33.8 (FY 1984)	1,200,000 (FY 1983)	14.4 (FY 1985)
Britain	5.2 (FY 1984)	43.6 (FY 1982)	960,000 (FY 1982)	6.6 (FY 1984)
West Germany	9.8 (FY 1985)	19.6 (FY 1983)	520,000 (FY 1983)	11.4 (FY 1985)
France	14.0 (FY 1985)	5.3 (FY 1980)	160,000 (FY 1980)	8.4 (FY 1985)

Source: Keidanren Review, No. 95, October 1985

Japan's monetary policy in 1985 has been constrained by exchange rate considerations. Money supply growth has been restrained and the official discount rate has remained at 5 percent. The government and the Liberal Democratic Party agreed in late December to pursue a more flexible monetary policy to stimulate domestic demand, and that is thought to include a cut in the discount rate. Monetary policy, though, is likely to continue to be linked to exchange rate considerations.

Conclusion

Japan's real economic growth in FY 1986 should be about 3 percent, with the private sector contributing about 2.5 percentage points, government 0.5 to 0.7 point and the external sector exerting a small drag. The overall effect of the yen appreciation should be negative, slowing growth from the 4 percent to 5 percent range of the past two fiscal years.

A contrasting opinion is held by the EPA, however. The example of the United States indicates that an appreciating currency need not lead to slower economic growth. Rapid U.S. growth was accompanied by a 60 percent rise since 1980 in the trade-weighted value of the dollar. But an obvious difference in the two cases is that the appreciation of the dollar was, in large measure, the result of an expansionary fiscal policy that encouraged growth. In Japan, the

appreciation of the yen has been encouraged by higher interest rates that have discouraged growth. Given Tokyo's fiscal situation and the need to raise the value of the yen in order to reduce protectionist pressures, monetary policy was the logical policy choice to drive up the yen. Large U.S. budget deficits have forced Japan and other countries to run tighter monetary policies than they would otherwise pursue in order to defend their currencies.

Reflecting the view that business expansions die of old age, some observers note that the current Japanese slowdown reflects the maturing of the economy and that a turning point should be expected. This does not appear to be true in the United States, where the probability of the onset of a recession is only weakly related to the age of the expansion. Instead, recessions have been associated with prior outbreaks of inflation, as public policy responses to rising prices have put downward pressure on output and employment.

The swings in the Japanese economy since 1975 have largely been a result of changes in exports, as dependence on external demand has made the country vulnerable to changes in economies abroad, particularly the United States'. If Japan is able to return to growth based primarily on domestic demand, it should be able to enjoy a period of steady expansion, since inflation seems to be well under control.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japane Economic Institute.